

# IRA ROLLOVER GUIDE

Distribution Options • Tax Rules • Retirement Income Strategies • Estate Planning



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## Executive Summary

### The Changing World of Work

Most workers in the United States count on employers to help them save for a financially secure retirement. Employer-sponsored retirement plans such as 401(k) plans and profit sharing plans hold more than \$24 trillion in retirement savings.<sup>1</sup>

One of the most important financial decisions workers will make is what to do with assets they have accumulated in their employer's retirement plan when they leave their job. Traditionally, this decision needed to be made when workers retired, but it's not just a retirement issue anymore.

Today, most workers will change jobs several times during their working years. Unlike past generations that may have spent most of their career with a single employer, the median tenure for a worker today is only 4.6 years.<sup>2</sup> Each worker who decides to go to work for a new employer may be faced with the decision of what to do with the retirement plan assets in the prior employer's plan. The choices workers make each time they change jobs will have a significant impact on their retirement nest eggs.

In addition to job changers, more than 70 million baby boomers will reach retirement age and will likely leave the work force over the next 20 years. Each of these baby boomers will need to decide what to do with the funds they have saved through their employers' retirement plans.

### Exploring Options

Most workers will have four options for their retirement plan assets when they leave an employer:

- Leave the assets in the prior employer's plan
- Roll the assets to a new employer's plan (if continuing to work and plan is available)
- Roll the assets to an IRA
- Cash out the retirement savings

Determining which option is best can be challenging for individuals. There is no "one size fits all" solution. The best choice will vary depending upon an individual's unique financial needs and savings objectives.

Many workers have chosen to roll their savings from their prior employer's plan into an IRA. IRAs currently hold \$7.3 trillion, representing a substantial portion of overall retirement savings in the U.S.<sup>1</sup> Rollovers from employer plans are the most significant source of dollars flowing into IRAs.<sup>3</sup> But, an IRA rollover is not the only option and it may not be the best choice for a particular individual. Regulatory agencies, including the Financial Industry Regulatory Authority (FINRA), the regulatory agency that oversees broker dealers, have emphasized how important it is for workers to understand all of their options and evaluate multiple variables when deciding whether to roll assets to an IRA.<sup>4</sup>

### The IRA Rollover Guide

The objective of the IRA Rollover Guide is to provide foundational education regarding how and when assets can be rolled among retirement arrangements. The Guide will highlight some of the variables that should be considered when evaluating the four distribution options and will describe the tax rules that apply to rollover transactions. The Guide also contains a Glossary of Terms (Appendix A) defining many of the common technical terms individuals may encounter as they explore IRA rollover options.

As with any important financial decision, an individual is often well served by seeking professional assistance. Financial advisors with investment expertise, as well as tax and legal advisers, can provide valuable support to individuals who want to learn more about IRA rollovers.

## Exploring Options

### When can money be paid out of a retirement plan?

Retirement plans offered by employers, such as 401(k), 403(b), profit sharing, and defined benefit plans, are designed to help workers save for retirement, not to help them manage their short-term spending needs. To discourage retirement plan savings from being depleted early, there are a number of tax rules that restrict access to retirement savings prior to retirement years. One of these rules allows distributions from an employer plan only after certain events occur. These are sometimes referred to as “distribution triggering events.” Two common triggering events are severance from employment and plan termination. Special triggering event rules apply to certain types of contributions. For example, an employee’s deferrals into a 401(k) plan can only be disbursed if the individual has reached age 59½, died, left the employer, become disabled, or the plan has terminated.

A rollover from an employer plan to an IRA generally cannot occur unless there has been a triggering event. Most IRA rollovers are triggered by workers leaving their employers. However, some plans are designed to permit rollovers of certain types of assets while an individual is still employed (e.g., assets originating from a prior employer’s plan). These types of distributions are referred to as “in-service” distributions.

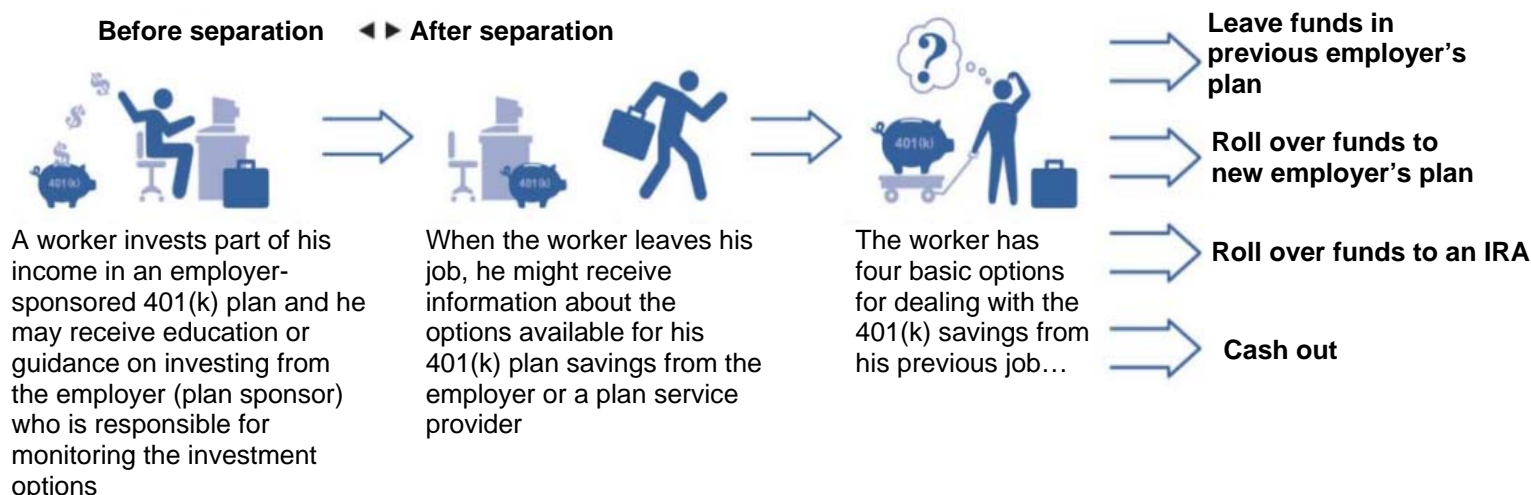
One way to identify triggering events that apply to a specific plan is to review the plan’s Summary Plan Description (SPD). This document describes the plan’s features, including distribution options, and must be provided to each worker who participates in the plan. Other sources for this information include the plan’s administrator or participant support services available online or through a call center.

**Automatic Rollovers** – Some rollovers occur automatically, even though an individual has not requested a payout from the employer plan. Many plans are designed to automatically pay out assets when a worker terminates employment if the individual has a plan balance less than \$5,000 and has not directed the plan administrator to either make a distribution or roll it to another plan. These payouts are sometimes referred to as “automatic rollovers” or “force-outs.”

- If the balance is \$1,000 or less, it may be simply cashed out and sent to the individual without the individual’s authorization.
- If the vested plan balance is between \$1,000 and \$5,000, the amount automatically disbursed from the plan must be rolled over to an IRA that is set up on behalf of the former employee.

### What options are available when a worker leaves an employer?

Once individuals are eligible to take a distribution in a defined contribution plan, they typically have four options:<sup>5</sup>



When a worker is eligible to take a distribution that may be rolled over, the plan administrator must provide a written explanation of the rules and tax consequences pertaining to the worker’s distribution and rollover options. These notices are sometimes referred to as “402(f) notices,” based on the section of the Internal Revenue Code that contains the requirements for this notice. These notices can be difficult to understand if written in complex language, but are one resource for exploring the worker’s distribution options. A copy of the distribution notice may be requested from the plan’s administrator.

## What variables should be considered by the participant when deciding what to do with employer plan assets?

### EVALUATING OPTIONS

#### OPTION 1: LEAVE FUNDS IN PREVIOUS EMPLOYER'S PLAN

##### POTENTIAL BENEFITS

###### Investment options

- Investment options are prudently selected & monitored by a fiduciary

###### Fees & fee disclosures

- Investment fees may be lower when offered through retirement plans as compared to individual retail accounts
- Fee disclosures must be provided to help individuals compare costs among plan investment options & to alert individuals to fees charged to their account
- Some administrative costs may be paid by the employer

###### Plan administration & other services

- Employer is responsible for administering the plan in compliance with various laws & regulations
- Plan may offer services such as access to investment advice, education, call center support

###### Distributions & loans

- Many plans allow loans, permitting access to plan assets with the ability to restore retirement savings
- Separation from service after age 55 is an exemption from the 10% early distribution tax (for distributions taken prior to age 59½) that is available for qualified plan distributions but not IRA distributions

###### Creditor protection

- Plan assets are not subject to creditor claims

###### Other considerations

- Pre-tax assets & tax-deferred earnings are not included in income until distributed from the plan

##### CONSIDERATIONS

###### Investments

- The menu of investments is determined by the plan fiduciary & may be narrower than in an IRA

###### Plan administration & other services

- Employer has the option to charge former employees' accounts for certain administrative fees that are not being assessed against current employees

###### Distributions & loans

- Plan may allow someone who is still employed to delay age 70½ required minimum distributions (RMDs)
- Some plans require loan repayments to be made through wage withholding, limiting loan access for former employees
- Plan may limit the types of distributions allowed, making it less feasible to take a stream of retirement income payments (commonly called "installment payments") or to implement estate planning strategies
- Many plans do not offer investments designed to provide long-term retirement income (e.g., annuities)

###### Other considerations

- If an individual has worked for several employers during their career, they may have assets in several different plans

## OPTION 2: ROLL OVER FUNDS TO NEW EMPLOYER'S PLAN

### POTENTIAL BENEFITS

#### Same potential benefits as leaving assets in previous employer's plan

- Ability to consolidate assets to simplify investment decisions & overall management of retirement savings

### CONSIDERATIONS

Need to compare investment options, plan features, & services in new employer's plan versus previous employer's plan

## OPTION 3: ROLL OVER FUNDS TO AN IRA

### POTENTIAL BENEFITS

#### Investments

- May have access to a broader range of investments than in an employer plan
- IRA owner can change investments at any time (subject to IRA provider requirements)

#### Fees & fee disclosures

- IRA provider is required to provide a disclosure statement explaining the features of the IRA, serving a purpose similar to the Summary Plan Description provided for employer plans

#### Plan administration & other services

- IRA trustee or custodian handles contribution and distribution reporting & will assist with age 70½ RMD calculations

#### Distributions & loans

- Distributions are available at any time
- Additional exemptions from the 10% early distribution tax (for distributions taken prior to age 59½) apply to IRA distributions (e.g., certain higher education expenses, first-home purchases)
- Roth IRAs are not subject to the age 70½ RMD rules
- Flexibility regarding distribution timing & amount can support retirement income & estate planning objectives

#### Creditor protection

- Creditor protection is available in some states (but not to extent applicable to employer plans)<sup>6</sup>

#### Other considerations

- IRA owner may be able to make annual contributions to IRAs
- Flexible conversion & re-characterization options enable IRA owners flexibility in deciding when to pay taxes on IRA assets
- IRAs may offer more flexible beneficiary options (e.g., stretch IRAs)

IRAs can be used to consolidate assets from multiple employer plans

### CONSIDERATIONS

#### Investments

- IRA owner is generally responsible for selecting & monitoring investments unless the IRA owner engages an advisor to provide discretionary investment services

#### Fees & fee disclosures

- Investment fees may be higher when offered through an IRA as compared to an employer-sponsored retirement plan
- The expansive fee disclosures provided to employer plan participants are not typically provided for IRAs

#### Plan administration & other services

- IRA owner is responsible for administering the IRA, with support from the IRA trustee or custodian
- Services may be more limited than offered in the employer plan (e.g., education, investment advice, support

line)

### Distributions & loans

- No plan loans permitted for IRAs
- A 10% early distribution tax applies to taxable distributions taken prior to age 59½, unless an exception applies

### Creditor protection

- IRAs are protected under federal bankruptcy law
- IRAs are not afforded the broad federal protection from other types of creditor claims available for employer plans; however, state law may provide certain protections<sup>6</sup>

### Other considerations

- RMDs must begin at age 70½ (traditional IRA)
- Employer stock rolled from an employer plan to an IRA will be taxed as ordinary income when distributed, whereas stock held in other types of accounts may qualify for capital gains treatment

## OPTION 4: CASH OUT

### POTENTIAL BENEFITS

#### Investments

- Access to a broad range of investments
- Freedom to change investments at any time (subject to investment requirements)

#### Fees & fee disclosures

- Investment provider will generally provide investment disclosures & account statements

#### Plan administration & other services

- Not subject to testing requirement & annual limitations applicable to employer plans & IRAs

#### Distributions & loans

- Access to assets at any time
- No age 70½ RMDs
- Flexibility regarding distribution timing & amount can support variety of retirement income & estate planning objectives

#### Other considerations

Possible tax diversification benefit, as assets will not be taxed again in retirement years (although future investment earnings will typically be taxable in the year they are earned)

### CONSIDERATIONS

#### Investments

- Individual is responsible for selecting & monitoring investments

#### Plan administration & other services

- Individual is responsible for overseeing investments, analyzing tax impact of distributions

#### Creditor protection

- Creditor protection is generally limited for non-retirement assets

#### Other considerations

- Taxation of all pre-tax amounts in year of distribution (e.g., employee deferrals, employer matching & profit sharing contributions)
- If assets are used, rather than saved, risk that retirement savings will be depleted
- 10% early distribution tax applies, if under age 59½ (unless exception applies)
- 20% mandatory withholding if taxable amounts eligible for rollover

### Special Considerations for Rollovers From Defined Benefit Plans

The distribution options available in defined benefit plans are different than those commonly available in defined contribution plans. Defined benefit plans offer payments in the form of a life annuity that is guaranteed for life. Unlike defined contributions plans, which base the distribution amount on the amount contributed to the plan (plus earnings), a defined benefit plan calculates the amount of the payments based on a formula that takes into account certain factors such as the employee's years of service with the employer, compensation, and age at retirement. These payments are not eligible to be rolled over to an IRA or another employer's plan. Some defined benefit plans also allow individuals to take a lump sum amount. This lump sum may be eligible to be rolled over to an IRA or another eligible plan. While the impact of rolling a lump sum to an IRA or a new employer's defined contribution plan would be the same as outlined in the previous charts, leaving assets in the former employer's defined benefit plan and taking distributions from the plan have some unique characteristics that should be taken into consideration.

#### Funding & Investments

- Plan sponsor is responsible for making contributions to fund the projected payments, based on actuarial calculations
- Plan sponsor selects & monitors investments and bears the investment risk

#### Distributions

- In-service distributions not permitted prior to age 62
- Predictable payment amounts (e.g., monthly) based on plan's benefit formula, not tied to investment performance
- Payments guaranteed for participant's life (or joint life of participant & spouse)
- Pension Benefit Guarantee Corporation (PBGC) guarantees payment up to a certain level if employer is unable to make payments
- Payments are usually locked in once they begin & cannot be changed




## Mastering the Mechanics of an IRA Rollover

The previous sections addressed when assets could be rolled over and what factors individuals may want to consider when evaluating whether an IRA rollover is appropriate for their retirement plan assets. In this section, we will address the mechanics of a rollover and introduce the players that are typically involved in a rollover.

### Eligible Plans & Eligible Assets

If an individual decides a rollover is the best option, they need to select an eligible retirement arrangement to receive the rollover. As discussed earlier in the *Guide*, an IRA is not the only option. In an effort to preserve retirement plan assets for retirement, the laws and regulations allow for fairly free movement of assets among different types of retirement plans. The following chart, created by the IRS, lists the types of plans and IRAs that can accept rollovers.

## ROLLOVER CHART

		Roll To							
		Roth IRA	Traditional IRA	SIMPLE IRA	SEP-IRA	Governmental 457(b)	Qualified Plan <sup>1</sup> (pre-tax)	403(b) (pre-tax)	Designated Roth Account (401(k), 403(b) or 457(b))
Roll From	<a href="#">Roth IRA</a>	YES <sup>2</sup>	NO	NO	NO	NO	NO	NO	NO
	<a href="#">Traditional IRA</a>	YES <sup>3</sup>	YES <sup>2</sup>	NO	YES <sup>2</sup>	YES <sup>4</sup>	YES	YES	NO
	<a href="#">SIMPLE IRA</a>	YES, <sup>3</sup> after two years	YES, <sup>2</sup> after two years	YES <sup>2</sup>	YES, <sup>2</sup> after two years	YES, <sup>4</sup> after two years	YES, after two years	YES, after two years	NO
	<a href="#">SEP-IRA</a>	YES <sup>3</sup>	YES <sup>2</sup>	NO	YES <sup>2</sup>	YES <sup>4</sup>	YES	YES	NO
	<a href="#">Governmental 457(b)</a>	YES <sup>3</sup>	YES	NO	YES	YES	YES	YES	YES <sup>3,5</sup>
	<a href="#">Qualified Plan<sup>1</sup> (pre-tax)</a>	YES <sup>3</sup>	YES	NO	YES	YES <sup>4</sup>	YES	YES	YES <sup>3,5</sup>
	<a href="#">403(b) (pre-tax)</a>	YES <sup>3</sup>	YES	NO	YES	YES <sup>4</sup>	YES	YES	YES <sup>3,5</sup>
	<a href="#">Designated Roth Account (401(k), 403(b) or 457(b))</a>	YES	NO	NO	NO	NO	NO	NO	YES <sup>6</sup>

<sup>1</sup> Qualified plans include, for example, profit sharing, 401(k), money purchase, and defined benefit plans

<sup>2</sup> Only one rollover in any 12-month period

<sup>3</sup> Must include in income

<sup>4</sup> Must have separate accounts

<sup>5</sup> Must be an in-plan rollover

<sup>6</sup> Any amounts distributed must be rolled over via direct (trustee-to-trustee) transfer to be excludable from income

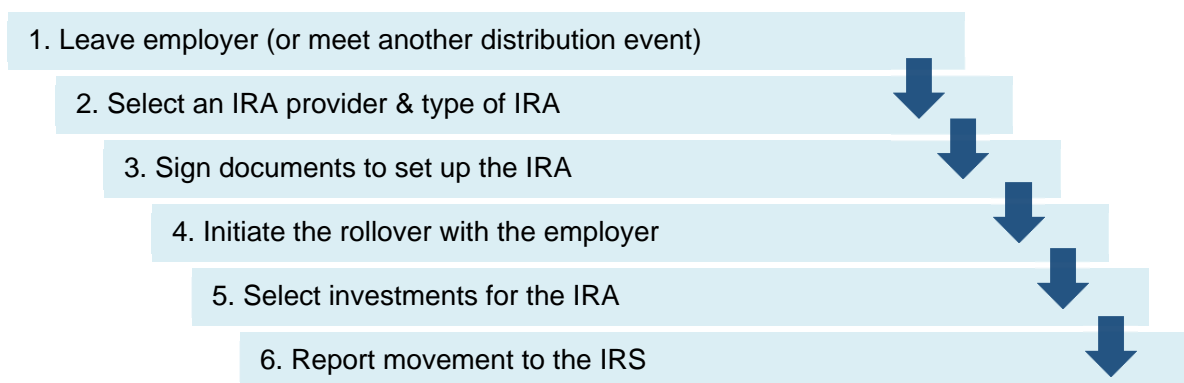
For more information regarding retirement plans and rollovers, visit Tax Information for Retirement Plans (<http://irs.gov/Retirement-Plans>)

The assets in an eligible employer retirement plan are generally eligible to be rolled over to another eligible plan or IRA. Certain types of distributions, however, are not eligible to be rolled over, even if there is a distribution event.

- Age 70½ required minimum distributions (RMDs)
- Hardship distributions
- A series of substantially equal periodic payments
- Corrective distributions (e.g., excesses distributed from a 401(k) plan)
- Dividends on employer securities that are distributed from a plan
- Certain costs for life insurance coverage (PS58 costs)

### IRA Rollover Process

Although there may be some variations based on the service providers, most IRA rollovers will include the following steps.



### Roles & Responsibilities

An IRA rollover will usually involve a number of different players.

ROLE	RESPONSIBILITIES
<b>IRA Owner</b>	<p>One of the prime characteristics of an IRA is that the IRA owner has control over the account, independent of an employer.</p> <ul style="list-style-type: none"> <li>■ Decide what type of IRA to establish – traditional or Roth</li> <li>■ Select an IRA provider who will administer the IRA</li> <li>■ Execute the IRA plan agreement and other required documentation to set up the IRA, review disclosures, &amp; designate beneficiaries</li> <li>■ Decide how much to roll over &amp; whether to make annual contributions in future years</li> <li>■ Select investments from among those available through the IRA provider</li> <li>■ Track taxation, including any nondeductible contributions made to traditional IRAs (IRS Form 8606, <i>Nondeductible IRAs</i>)</li> <li>■ Track timing rules such as the 5-year rule in connection with Roth contributions</li> <li>■ Report distribution from the plan &amp; contribution to the IRA, and any future IRA contributions &amp; distributions to the IRS on annual tax return (IRS Form 1040, <i>U.S. Individual Income Tax Return</i>)</li> <li>■ Decide when &amp; how much to distribute from IRA</li> </ul>
<b>Advisor</b>	<p>Financial advisors provide investment expertise &amp; help individuals evaluate the benefits of IRAs versus other savings options.</p> <ul style="list-style-type: none"> <li>■ Introduce possible IRA product &amp; service providers &amp; help evaluate the various options</li> <li>■ Serve as intermediary between IRA trustee or custodian &amp; individual, if appropriate, to deliver IRA set-up documentation</li> </ul>

	<ul style="list-style-type: none"> <li>■ Provide investment expertise to educate IRA owners about the various investment options</li> <li>■ Provide ongoing investment support to help the IRA owner monitor &amp; adjust investments</li> </ul>
<b>Trustee or Custodian</b>	<p>IRA assets typically must be held in a trust or in a custodial account for the benefit of the IRA owner (unless the assets consist only of insurance contracts). Most financial organizations that offer IRA products &amp; services can hold the IRA assets, serving as trustee or custodian &amp; provide the following services.</p> <ul style="list-style-type: none"> <li>■ Provide plan documents &amp; disclosures needed to open an IRA</li> <li>■ Provide documentation to initiate the rollover from the prior employer's plan</li> <li>■ Administer the rollover</li> <li>■ Draft &amp; deliver amendments when the laws &amp; regulations affecting IRAs change</li> <li>■ Prepare &amp; deliver annual notices to IRA owners</li> <li>■ Report information required by the IRS regarding IRA activity such as contributions &amp; distributions on IRS Form 5498, <i>IRA Contribution Information</i>, &amp; Form 1099-R, <i>Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.</i></li> <li>■ Administer contributions &amp; distributions requested by the IRA owner, including collecting &amp; remitting taxes</li> <li>■ Calculate age 70½ RMDs</li> </ul> <p>Provide regulatory compliance expertise, be available to provide answers to technical questions regarding the IRA rules</p>
<b>Other Service Providers</b>	<p>Because IRAs are often an element of an individual's estate plan or tax diversification strategy, IRA decisions may involve legal or tax advisors.</p> <ul style="list-style-type: none"> <li>■ An attorney may be retained to discuss various strategies for transferring property &amp; to draft legal documents, such as wills and trusts, that may be required to execute the individual's strategy</li> </ul> <p>An accountant may be needed to assess options for minimizing the tax implications of various savings &amp; retirement income strategies or when transferring property</p>

## Rollover Taxation Rules

The taxation of a rollover will be dictated by the types of plans and the types of assets involved in the rollover.

**Tax-free rollover from employer plan to IRA or another employer plan** – A rollover from an employer-sponsored retirement plan to a traditional IRA or to another employer plan is generally a tax-free movement of assets. Individuals can choose to roll over assets directly to the receiving IRA or employer plan. In a “direct rollover,” the check or wire is issued to the custodian or trustee of the IRA or other plan to be held for the benefit of the individual. Individuals can also choose to take a distribution from the plan and complete an “indirect rollover” or “60-day rollover” to an IRA or employer plan by re-depositing the assets within 60 days following the date of distribution.

There is no income tax withholding on a direct rollover – the assets are moved directly from the plan to the receiving IRA or plan. If the transaction is an indirect rollover (i.e., paid to the individual first), the employer must withhold 20% of the taxable distribution amount. To complete a tax-free 60-day rollover, an individual must make up the 20% withheld when making the rollover into the IRA or plan. If the 20% is not made up, it will be taxable to the individual in the year of distribution and may be subject to the 10% early distribution tax. (Individuals may recover some or all of the 20% withheld when they file their tax return for the year.)

**Tax-free rollovers & transfers among IRAs** – IRA owners can freely move assets directly between IRA trustees or custodians, referred to as a “transfer.” IRA owners can also move assets in the form of an indirect rollover. Individuals may conduct only one indirect rollover during any 12-month period, even if they have multiple IRAs.<sup>7</sup> This 12-month restriction does not apply to IRA transfers or to rollovers from employer retirement plans.

**Taxable rollover/conversion from employer plan to Roth IRA** – An individual can make a taxable rollover, also known as a conversion, from an employer plan to a Roth IRA. This transaction is taxable because assets in the plan that have not yet been taxed (e.g., employee deferrals, employer matching and profit sharing contributions) are moved into an account that only accepts after-tax assets (a Roth IRA). The amount

being rolled is taxed in the year it is distributed from the plan. When the assets are ultimately distributed from the Roth IRA, the rollover amount can be taken out tax free. Any additional earnings in the Roth IRA will also be tax free if the distribution is considered a “qualified distribution.”

*Taxable conversion from traditional IRA to Roth IRA* – Similar to the taxable rollover option between an employer plan and a Roth IRA, traditional IRA assets may be moved to a Roth IRA in a taxable transaction referred to as a conversion. This option enables an IRA owner to decide when to pay taxes on certain assets. Traditional IRA account owners should consider the tax ramifications, age and income restrictions in regards to executing a conversion from a Traditional IRA to a Roth IRA.

## Understanding the Role of the IRA in Retirement Income Strategies & Estate Planning

### Access to IRA Assets

One of the benefits often cited for an IRA is the flexibility of being able to take an IRA distribution at any time. However, because IRAs were designed to help individuals save for retirement, Congress created rules to discourage individuals from withdrawing funds from their IRAs prior to their “retirement” years. The distribution timing rules can have a big impact on how IRAs will be used to fund retirement or other wealth management strategies.

**Before age 59½** – An additional 10% early distribution tax applies to the taxable portion of any distribution taken prior to age 59½. There are some exceptions to the early distribution tax as highlighted below.

**After age 59½** – Once an individual reaches age 59½, the option to take a distribution at any time continues and the 10% early distribution tax no longer applies.

**Age 70½** – The year an individual attains age 70½ and every year thereafter, required minimum distributions (RMDs) must be taken from traditional IRAs.

### Avoiding the 10% Early Distribution Tax

An IRA distribution taken prior to age 59½, like a qualified plan distribution, is generally subject to a 10% early distribution tax on the taxable portion of any distribution. This tax is in addition to income tax that may be owed on the distribution. Individuals may avoid the 10% early distribution tax if they qualify for one of the exceptions to the tax listed below.<sup>8</sup> The exceptions noted with an asterisk (\*) are available for IRA distributions but not qualified plan distributions. The ability to access retirement assets free from the additional 10% tax is one of the variables that may influence the IRA rollover decision for certain individuals.

- Unreimbursed medical expenses exceeding 10% of an individual's adjusted gross income (Individuals with a spouse age 65 or older may apply a rate of 7.5% through 2016 under a transition rule.)
- Health insurance premiums following unemployment \*
- Disability
- Death
- Attainment of age 59½
- Qualified higher education expenses \*
- First-time home purchase (up to \$10,000)\*
- IRS levy (used to satisfy a tax debt)
- Distributions by a qualified Reservist
- Substantially equal periodic payments

One of the most common techniques used to access IRA assets before age 59½ is to take “substantially equal periodic payments.” This option can be used at any age. Under this exception to the 10% tax, IRA owners set up a schedule of “substantially equal” payments. The payments must be made at least annually and must be made for a certain period of time. The amount of each year’s payment is typically calculated using one of three methods outlined in IRS guidance: the required minimum distribution method, the annuitization method, or the amortization method.

The IRA owner must receive a payment at least annually until he or she reaches age 59½ or for 5 years, whichever period is longer. If the series of substantially equal periodic payments stops or is modified before the end of the minimum payment period, the protection from the 10% tax is lost and the IRA owner will be required to pay the 10% early distribution tax retroactively for the distributions that occurred each year the arrangement was in place, plus interest.

## RMD Rules

Required minimum distributions (RMDs) are an important consideration in any retirement income strategy and may play a role in estate planning. Traditional IRAs must begin disbursing a portion of the IRA each year once an individual reaches age 70½. Each year's RMD is calculated by taking the IRA's prior-year December 31 balance and dividing it by a life expectancy factor, typically based on the age of the IRA owner. The RMD rules determine the minimum payment an IRA owner must take from an IRA each year. Most IRAs will allow the IRA owner to take larger payments than required under the RMD rules.

If an IRA owner fails to take an RMD for a year, a 50% excess accumulation tax applies to the portion of the RMD amount that should have been distributed but remained in the IRA. Although IRA owners are ultimately responsible for calculating and distributing their RMDs, many IRA trustees and custodians automatically calculate the RMD amount for the IRA owner. Those who do not routinely notify IRA owners of the RMD amount must calculate the RMD for the IRA owner upon request.

### People who may find a rollover or conversion to a Roth IRA appealing include individuals who:

- Want to pay the tax at today's tax rates on an investment they believe will significantly appreciate in value
- Are younger individuals, who may be in a lower tax bracket today, or who have many years to accumulate tax-free earnings
- Are interested in diversifying the tax nature of their retirement savings or those who expect tax rates to be higher in the future
- Are highly compensated employees who have not been able to contribute to a Roth IRA because of the earned income restrictions but can create tax diversification by contributing to a Roth inside an employer-sponsored retirement plan such as a 401(k) plan and rolling assets tax-free to a Roth IRA, or initiating a taxable rollover of pre-tax assets to a Roth IRA
- Want to avoid required minimum distributions in order to preserve assets and accumulate earnings as long as possible
- Want to pay the taxes on the assets during their lifetime and provide tax-free assets to heirs

## Inheriting IRA Assets

When an IRA owner dies, the beneficiary named by the IRA owner assumes the legal rights to the IRA. Unless the estate is named as the beneficiary, IRA assets pass to the beneficiary without having to go through probate proceedings. Beneficiaries may take a distribution of the entire IRA at any time. If the beneficiaries prefer to spread the payments over a period of years, they must deplete the IRA within certain time frames set forth in federal tax law. The amount and timing for a beneficiary's required distributions varies depending on three factors.

- Relationship to the IRA owner – spouse beneficiaries have more flexible options
- Whether the IRA owner died before or after becoming subject to the RMD rules
- Type of IRA

**Death Before RMDs** – For a traditional IRA, if the IRA owner dies before they were required to begin taking RMDs (April 1 following the year the IRA owner reaches age 70½), a beneficiary may take distributions calculated under the 5-year rule (take all assets out within 5 years) or the life expectancy rule (minimum annual distributions based on the beneficiary's life expectancy). Spouse beneficiaries have the additional option to transfer or roll over assets to their own IRA or another eligible retirement plan such as a 401(k) plan in which the surviving spouse participates.

**Death After RMDs** – If a traditional IRA owner died after RMDs were required to begin, a beneficiary must, at a minimum, take life expectancy payments each year. The 5-year rule is no longer available. Spouse beneficiaries may again transfer or roll over the assets to their own IRA or eligible retirement plan.

**Roth IRAs** – Roth IRAs are not subject to the RMD rules while the IRA owner is alive. When a Roth IRA owner dies, the beneficiary payout options are generally the same as the options that would apply for IRA beneficiaries if a traditional IRA owner dies before RMDs.

One strategy for leaving assets to heirs that has received a lot of attention is referred to as a “stretch IRA.” This strategy applies the RMD and beneficiary timing rules to minimize the amount distributed from an IRA during the IRA owner’s lifetime and maximize the amount left to heirs. The stretch IRA is a distribution strategy and not a separate type of IRA or IRA investment. Under the stretch IRA strategy, the IRA owner typically distributes only the minimum payment required under the RMD rules during their lifetime (assuming they reach age 70½). The IRA owner’s objective is to ensure as much of the IRA as possible remains invested for as long as possible, so the assets can grow tax-deferred (or in the case of the Roth IRA, tax free). With careful beneficiary planning, the IRA owner may be able to spread the IRA distributions over a significant number of years across multiple generations.

If the trustee or custodian permits, a beneficiary may move inherited IRA assets into a separate inherited IRA. This is a new IRA established with inherited IRA documents and funded with a transfer of inherited assets after the death of the IRA owner. Individuals who inherit assets from employer plans may also be able to directly roll assets into an inherited IRA.

Traditional IRA assets will be included in the beneficiary’s taxable income in the year the distribution is received (excluding any basis created by nondeductible contributions). The taxation of Roth IRA distributions will vary depending upon whether the distribution is “qualified” (i.e., the Roth IRA satisfied the 5-year aging requirement). Qualified distributions will be tax free to beneficiaries. If a distribution is not qualified, the earnings portion of the distribution will be taxable to the beneficiary, but the amount representing the original Roth contributions will be tax free.

### **Trusts & Estates as IRA Beneficiaries**

IRA owners have the option to name a trust or charity, or an estate, as the IRA beneficiary. Naming a trust as beneficiary enables the IRA owner to dictate to some extent how the IRA assets will be disbursed after their death. These arrangements are sometimes referred to as “trusteed IRAs.” Trusts are also used in some estate planning strategies to minimize the impact of estate taxes. Some IRA owners choose to name their estate as their beneficiary. The assets would then be handled according to the terms of the IRA owner’s will.

If an estate or trust or other entity that is not a person, such as a charity, becomes an IRA beneficiary, it has more limited payment options than a person would have. In addition to taking a lump sum payment, if death occurred before the IRA owner was required to begin RMDs, a beneficiary who is not a person generally must take distributions under the 5-year rule. There are exceptions for certain types of qualified trusts, which have an option to take life expectancy payments. If death occurred after RMDs were required to begin, a beneficiary who is not a person may take life expectancy payments based on the decedent’s remaining life expectancy.

The tax rules and legal implications of naming estates and trusts as beneficiaries can be complex. Tax or legal advisors will often be needed to create the necessary legal documentation to implement an individual’s particular strategy.

## Trusteed IRAs

A Trusteed IRA, also known as an Individual Retirement Trust (IRT), is a trust account that integrates IRA retirement savings goals with estate planning objectives. For tax purposes, a Trusteed IRA is treated the same as any other IRA. The difference between an IRT and a custodial IRA stems from how the IRA assets are handled when an IRA owner dies. With a typical custodial IRA, an IRA owner's beneficiary takes full control of the inherited IRA assets upon the death of the IRA owner. The beneficiary determines when and how much will be distributed from the IRA, so long as the beneficiary takes at least the minimum annual payment dictated by the Internal Revenue Code.

In a Trusteed IRA, the IRA assets will be disbursed by the trustee according to a schedule or a set of conditions defined by the IRA owner prior to their death. The IRA owner and his or her attorney will usually work with the IRA trustee to draft a beneficiary designation and trust agreement that will dictate how the IRA assets will be distributed, subject to the minimum payment requirements under the Internal Revenue Code. There are a variety of scenarios in which this level of control over IRA distributions may be appealing to an IRA owner. Some examples include IRA owners who want to

- Create a plan to handle the financial needs of minor children or a dependent with special needs
- Stretch IRA assets across multiple generations by restricting the payment amounts to the minimum required beneficiary payments (sometimes referred to as "stretch IRAs")
- Set certain conditions on the receipt of IRA assets (e.g., attaining a certain age, completing college)
- Provide financial support to a surviving spouse while ensuring the remaining assets pass to the children of a prior marriage

IRA owners should carefully weigh the benefits along with the costs of a Trusteed IRA. Trust documents and customized beneficiary designations will need to be created, usually by tax and legal professionals. There will also be trustee fees associated with administering the IRA.

## Summary

Deciding what to do with assets saved in an employer-sponsored retirement plan is one of the most important financial decisions a worker will make. For more information about distribution options, including IRA rollovers, check out some of the Internal Revenue Service and Department of Labor resources listed in the Appendix B – *Links to Additional Rollover Resources*. Refer to the *Glossary of Terms* (Appendix A) for definitions of common technical terms that may appear in marketing and educational materials relating to IRA rollovers.

As with any important financial decision, an individual should consider seeking professional assistance. Financial advisors with investment expertise, as well as tax and legal advisers, can provide valuable support to individuals who want to learn more about IRA rollovers.

## Footnotes

<sup>1</sup> Investment Company Institute (ICI), *The U.S. Total Retirement Market, Third Quarter 2014*, [www.ici.org](http://www.ici.org)

<sup>2</sup> U.S. Bureau of Labor Statistics, *Employee Tenure Summary*, September 18, 2014, [www.bls.gov](http://www.bls.gov)

<sup>3</sup> Employee Benefit Research Institute (EBRI), *Issue Brief No. 399, "Individual Retirement Account Balances, Contributions, and Rollovers, 2012; With Longitudinal Results 2010–2012: The EBRI IRA Database"* May 2014, [www.ebri.org](http://www.ebri.org)

<sup>4</sup> Financial Industry Regulatory Authority (FINRA), *Regulatory Notice 13-45*, December 2013, [www.finra.org](http://www.finra.org)

<sup>5</sup> U.S. Government Accountability Office (GAO), *401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants*, GAO-13-30, [www.gao.gov](http://www.gao.gov)

<sup>6</sup> AICPA, *The Tax Adviser: Protection From Creditors for Retirement Plan Assets*,

<http://www.aicpa.org/Publications/TaxAdviser/2014/January/DownloadableDocuments/statelIRChart.pdf>

<sup>7</sup> IRS, *Publication 590-A, Contributions to Individual Retirement Arrangements (IRAs)*, 2014, [www.irs.gov](http://www.irs.gov)

<sup>8</sup> Internal Revenue Code Section 72(t)

## Appendix A – Glossary of Terms

**Beneficiary** – A person or entity chosen by the IRA owner or retirement plan participant to inherit the assets after the individual dies

**Conversion** – A taxable movement of assets from a pre-tax account (e.g., traditional IRA or 401(k) plan) to a Roth IRA, which is an after-tax account

**Early Distribution** – An additional 10% tax that applies to the taxable portion of any distribution taken prior to age 59½; some exceptions apply

**Excess Accumulation** – An account owner or beneficiary who fails to take a required distribution for a year is subject to a 50% tax on the portion of the amount that should have been distributed but was not

**Excess Contribution** – An amount that exceeds the annual contribution limit for the year or another contribution limit imposed on an IRA or employer-sponsored retirement plan

**Fiduciary** – An individual or entity who manages an employee benefit plan and its assets must, under the Employee Retirement Income Security Act of 1974 (ERISA), follow strict standards of conduct, act in the sole interests of plan participants, and handle plan assets properly

**Five-Year Rule** – Requires a beneficiary to distribute 100% of the IRA or plan account by December 31 of the year containing the fifth anniversary of the account owner's death

**Inherited IRA** – An IRA that is set up and maintained in the name of the deceased account owner for the benefit of the beneficiary

**IRA** – An Individual Retirement Arrangement (IRA) is a personal savings account or annuity that provides tax advantages for setting aside money for retirement

**Life Expectancy** – Used to measure the maximum number of years over which an account owner or beneficiary is allowed to take distributions (IRS life expectancy tables are included in IRS Publication 590-B, *Distributions from Individual Retirement Arrangements*)

**Qualified Distribution** – A distribution from a Roth IRA or a designated Roth account in a 401(k), 403(b), or governmental 457(b) plan that will be tax-free because it is made after the account owner has met a 5-year holding period and has turned age 59½, become disabled, or died (or for Roth IRAs only, meets the first-time homebuyer exception)

**Recharacterization** – Treating a current-year contribution made to one type of IRA as having been made to a different type of IRA

**Required Beginning Date** – The date by which required minimum distributions must begin: April 1 of the year following the year in which the account owner attains age 70½

**Required Minimum Distribution (RMD)** – An amount that must be distributed to the account owner each year beginning with the year the account owner attains age 70½

**Rollover** – A distribution from an IRA or retirement plan that is moved directly or indirectly within 60 days to a receiving IRA or retirement plan

**Roth IRA** – An IRA that accepts only nondeductible (after-tax) annual contributions and provides tax-free earnings if distributions are qualified; may accept rollovers from other Roth IRAs and pre-tax assets and designated Roth account assets from employer-sponsored retirement plans

**Traditional IRA** – The original IRA (also called an ordinary or regular IRA) to which annual contributions are generally tax-deductible; may accept rollovers from other traditional IRAs and employer-sponsored plans

**Transfer** – A tax-free movement of assets directly between IRAs of the same type

**Withholding** – Amount that a payer of an IRA or retirement plan distribution withholds from a taxable distribution and remits to the IRS as a pre-payment of income tax on the distribution



## Appendix B – Links to Additional Rollover Resources

### IRS Resources

**Publication 590-A, *Contributions to Individual Retirement Arrangements*** – A publication that covers the rules regarding contributions to traditional and Roth IRAs, as well as the rollover and conversion rules <http://www.irs.gov/pub/irs-pdf/p590a.pdf>

**Publication 590-B, *Distributions from Individual Retirement Arrangements*** – A publication that covers the rules regarding distributions from traditional and Roth IRAs, as well as the rules for required minimum distributions and IRA beneficiaries <http://www.irs.gov/pub/irs-pdf/p590b.pdf>

**IRS Rollover Chart** – An at-a-glance summary of all eligible rollovers between retirement plans and IRAs [http://www.irs.gov/pub/irs-tege/rollover\\_chart.pdf](http://www.irs.gov/pub/irs-tege/rollover_chart.pdf)

**Traditional & Roth IRA Comparison Chart** – An at-a-glance comparison chart of the similarities and differences between traditional and Roth IRAs <http://www.irs.gov/Retirement-Plans/Traditional-and-Roth-IRAs>

**Required Minimum Distributions for IRA Beneficiaries** – A summary chart of the distribution options for spouse, non-spouse, and non-individual beneficiaries <http://www.irs.gov/Retirement-Plans/Required-Minimum-Distributions-for-IRA-Beneficiaries>

### Department of Labor Resources

**Retirement Toolkit** – A publication and a timeline provided by the DOL, the Social Security Administration, and the Centers for Medicare & Medicaid Services to help individuals understand the issues to consider when deciding when to retire <http://www.dol.gov/ebsa/pdf/retirementtoolkit.pdf>

**Savings Fitness: A Guide to Your Money and Your Financial Future** – A guide to assist individuals in learning about retirement plans and setting financial and retirement goals <http://www.dol.gov/ebsa/pdf/savingsfitness.pdf>

**What You Should Know About Your Retirement Plan** – An overview of the information a plan is required to disclose to employees and participants <http://www.dol.gov/ebsa/pdf/wyskgreenbook.pdf>

**Top 10 Ways to Prepare for Retirement** – Short, helpful hints to assist individuals in preparing for retirement, with links to more information <http://www.dol.gov/ebsa/pdf/top10ways.pdf>

**Taking the Mystery Out of Retirement Planning** – A guide to assist individuals in calculating how much to save for retirement and planning for expenses in retirement <http://www.dol.gov/ebsa/pdf/nearretirement.pdf>

### LPL Resources

For questions about your IRA rollover options and other issues, please contact your Financial Advisor for assistance.

